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DIRECTORATE OF
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Intelligence Memorandum

International Finance Series No. 29

The International Monetary Crisis

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
August 1971

INTELLIGENCE MEMORANDUM

THE INTERNATIONAL MONETARY CRISIS

The Dollar Floats

1. The measures announced by President Nixon on 15 August are intended to bring about a substantial de facto devaluation of the dollar. The decision to let the dollar float by cutting it off from gold puts the ball squarely in the court of foreign countries. They will decide whether, in effect, to let the dollar be devalued and by how much. The import surcharge is a lever to pry adequate exchange rate adjustments from the governments.

2. For years the dollar holdings of foreign central banks have exceeded US gold reserves. Apart from a common desire to cooperate in maintaining a stable international monetary system, the principal deterrent to large-scale raiding of US gold reserves has been the realization that the United States would close the gold window. This action would, it was feared, bring serious risks to monetary stability and world trade. In this situation, foreign governments had an ambivalent attitude about the dollar. On the one hand, they were increasingly resentful of US policies which gave rise to growing balance-of-payment deficits and, consequently, to a growing accumulation of unwanted dollars. On the other hand, they were, with few exceptions, unwilling to make trade and payments adjustments to reduce the US deficit. Individual countries handled the surplus of dollars in different ways. Japan accumulated dollars. Germany at first did the same, then floated, as its dollar holdings neared $13 billion beginning last May. Canada floated. France, subject to less pressure, used controls to slow the inflow. As US deficits grew and central banks were increasingly called upon to convert dollars into national currencies, the temptation mounted for them to cash these dollars into gold. But except for "nibbling," mainly by the smaller nations, the central banks continued to hold the dollars.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

3. For the larger dollar holders the option of cashing in dollars for gold was not a real one even before the US action, because of the inadequacy of the US gold stock in relation to the claims against it. The other options – to hold more dollars, or to assent to devaluation of the dollar in relation to other currencies in order to reduce the US deficit – remained unchanged. There has been an important change, however, in the way these options present themselves.

4. The psychological impact of cutting the tie with gold is important. Countries can no longer accumulate dollars and still claim to be on a gold standard. For many countries, especially in Europe, this is an important loss, even though they realized that convertibility in gold was largely illusory. They felt that the commitment to convertibility could impose a certain restraint on US economic policy. The smaller countries, moreover, could and did exercise their right to turn in dollars for gold. With the gold link cut, continuing to accumulate dollar reserves seems to many foreign governments tantamount to formally accepting a dollar standard. Consequently, central banks' confidence in the dollar and their willingness to increase dollar holdings have been reduced by the United States' actions, and expectations of a dollar devaluation have greatly increased throughout the world. Moreover, these actions make changes in exchange rates between the dollar and foreign currencies look more like a devaluation of the dollar than a revaluation of the foreign currency, which for some governments had been politically even more difficult to accept.

5. The immediate foreign reaction to the US move was one of shock, and most foreign exchange markets were closed for a week. As before, the European Community members tried but failed to agree on a common policy. Most nations have attempted to continue their recent policies as closely as possible. But because they wanted to minimize further increases in dollar reserves, they have been forced to permit greater flexibility in exchange rates. As of 24 August the currencies of most industrial countries (Japan and Switzerland were the major exception) were floating to some degree against the dollar. The German mark resumed its float. The Belgian franc and the Dutch guilder were floating jointly against the dollar (previously the Dutch were floating but the Belgians were maintaining a fixed parity for commercial transactions). The British pound and the Italian lira were floating within limits of 3%-4% around the previous parity. The French stuck to the old parity (and the previous bands) for commercial transactions, but, unlike the week before, allowed the dollar to float in a market for financial transactions.

Factors Affecting Foreign Reactions

6. Foreign governments' reactions to the US policy measures reflect differences in balance-of-payment positions, in degree of dependence on the US market, and in the systems of and attitude toward controls. The US deficit on current and long-term capital transactions (the "basic balance") was about $3 billion in 1970, roughly equal to the basic balance deficit with Canada and Japan (about $1.6 billion each, see Table 1). The United States had a small basic balance surplus with the European Community and Western Europe as a whole. It is to the European Community countries, however, that the bulk of the short-term capital outflow, which resulted in a large US deficit on an official settlement account, was directed. These payments patterns have continued in 1971, as basic deficits with Japan and Canada and the outflow of short-term funds to Western Europe increased further.

7. Canada and Japan are the countries most dependent on the US market. About two-thirds of Canada's exports and one-third of Japan's go to the United States (see Table 2). This compares with about one-eighth for the United Kingdom, about 10% for Germany and Italy, and 5% for France.

8. In the current situation, strong speculative forces have forced countries not floating their currencies to use controls over capital movements at the very least. The effectiveness of the system of controls varies widely among countries. The French are not reluctant to use direct controls to achieve national objectives. Much like the Japanese they have maintained tight controls over capital movements, which have slowed, although not stopped, the capital inflow. The Germans, on the other hand, generally find controls distasteful and, unlike France, do not in fact possess an institutional mechanism that could effectively keep out capital movements.

Canada

9. The US measures create difficult problems for Canada, whose economy is closely integrated with that of the United States. Between last year's decision to float the Canadian dollar and President Nixon's announcement, the Canadian dollar appreciated almost 7% relative to the US dollar. Since the announcement it has risen another two points, nearly to a one-for-one ratio. In addition, the import surcharge applies to about one-fourth of Canadian exports to the United States, even though trade under the automobile agreement is exempted. Canada's trade surplus with the United States has continued to grow in spite of the appreciation of the Canadian dollar. This is a result primarily of booming exports of raw

materials, which are not much affected by possibly temporary price changes, and of the impact of the automobile agreement. The unfavorable impact of the currency appreciation on other Canadian exports of manufactures is not yet apparent.

10. The Canadians clearly would much prefer continuing to run large surpluses with the United States to seeing a large curtailment of their exports and an increase in their imports. The Canadian Government believes that rapid growth of manufacturing is necessary to provide jobs for the rapidly expanding labor force and that manufacturing cannot develop efficiently without exports to the large US market. It is thus unlikely that the Canadians will be willing to let their currency appreciate to the point that many of their manufactures would become priced out of this market. The fact that Canada is currently in a recession, with unemployment about 6% of the labor force, makes matters particularly difficult.

Japan

11. Japan for several years has earned large surpluses both in its overall balance of payments and in its payments with the United States. Foreign exchange reserves, which were $2 billion three years ago and $4.8 billion at the end of last year, reached about $12.5 billion on 21 August. While Japan's basic balance surplus (seasonally adjusted) has been running at an annual rate of about $4 billion so far this year, the increase of $2.3 billion in reserves in the past two weeks was largely due to inflows of short-term capital despite tight controls.

12. An extremely rapid growth of exports has been a key ingredient of Japan's highly successful economic growth strategy. [redacted] 25X6

Western Europe

13. While West European countries depend relatively little on the US market, they are extremely dependent on each other. About 50% of the trade of European Community countries, for example, is within the Community and some 20% is with other European countries. The European share of total exports ranges from 38% for the United Kingdom to almost 80% for Belgium, with most countries around 60% (see Table 3). At the same time, the balances of payments of the major West European countries are in approximate overall equilibrium, and, consequently, none of them can afford to revalue its currency substantially unless others do the same. Even the German mark, generally considered Europe's strongest currency, probably could not be revalued more than 5% or so relative to the other European currencies without putting German exporters at a competition disadvantage. If the European currencies are all revalued to some degree relative to the dollar, the chances that any of them will experience serious worsening in their balance of payments will be greatly reduced. Most are highly reluctant to do even this, however, and in the absence of agreement among the EC countries, all are likely to intervene in the market to prevent their exchange rate from getting out of line with those of the others.

Likely Short-Term Impact

14. Differences in interests and attitudes make it unlikely that agreement on international financial reform will be achieved soon. For a while, perhaps even several months, each country will probably continue something like its current policies, and in these conditions an integrated international monetary system will not exist. This is bound to cause disruptions of trade and finance; nevertheless, international trade by and large will continue along normal lines, and capital movements should be less troublesome than prior to the US decision to float. With most foreign currencies floating in regard to capital transactions, foreign holders of dollar assets will no longer be able to sell much of their dollars without pushing down the exchange rate below a level that they would expect to be sustained. Initial exchange rate changes after the major European foreign exchange markets reopened on 23 August were surprisingly small. The dollar depreciated only 1%-2% in the British, Italian, Belgian, and Dutch markets, and only 6% in the German market.

15. Financial disruptions are likely to result not so much from floating exchange rates – experience with these has not been unfavorable – but rather from maintenance by some countries of relatively fixed parities supported by exchange controls. Controls will not suppress expectations of eventual revaluation. They will also tend to divert capital flows to countries retaining a freer system, thereby pushing up their exchange rates.

16. The US import surcharge also will create problems. It will hit more painfully those countries whose currencies have floated upward than those that have maintained the old parities, although some countries may temporarily subsidize exports. Apart from some danger of foreign retaliation and uncertainty about the manner of its implementation, there will be speculation about when the surcharge will be removed. Because of these uncertainties, some exporters and importers may be holding off in the expectation of better terms in the future.

17. Within the European Community, progress toward monetary integration will stop temporarily, and other forms of cooperation could be hindered if the French-German policy split continues. Existing cooperative arrangements will probably not be disrupted. Even though agricultural prices in the Community are fixed in terms of dollars, agricultural trade will not be affected, because of the system of compensation for price discrepancies that result from exchange rate variations. This arrangement, however, is only a stop gap, and pressures to return to fixed parities will build up.

The Longer Term

18. As time goes on, nations will feel an increasingly pressing need to develop a new international monetary system. Universal adoption of flexible exchange rates is a possible solution. More and more countries may well find that flexibility, far from bringing chaos, solves many problems. But opposition to such a solution remains strong, especially on the part of central bankers. More likely would be a return to a new set of fixed parities, probably with exchange rates allowed to fluctuate within wider bands than before and perhaps with some provision or understanding to facilitate adjustment of parities in the longer term.

19. Arriving at an agreement on new parities, however, will not be easy. The US Government wants a sufficient devaluation of the dollar to eliminate the chronic US balance-of-payments deficit. Foreign governments would prefer a smaller devaluation. There are wide disagreements about the role of gold and the dollar in the international monetary system and on the type and use of any new international currency that may be formed.

20. The critical element in the determination of new exchange rates and new uses of international liquidity may well be the nature of any agreement among EC members. If the EC countries agree to new exchange rates among themselves that involve a substantial average devaluation of the dollar, there should be few obstacles to agreement on a global scale, and Japan would find accommodation relatively easy. But if the EC countries agree to exchange rates involving only a small average dollar

devaluation, or none at all, an impasse may result. It is possible that the Europeans would then move to link their currencies to gold or some new EC unit of account and to establish tight controls over dollar transactions, at least on capital account. To balance its payments, the United States would have to bargain bilaterally with the Europeans as a group and with the Japanese and the Canadians.

Table 1

Measures of the US Balance of Payments with Selected Foreign Areas 1970

	Million US $
All Areas	
Merchandise trade balance	2,110
Current account balance	444
Basic balance	-3,038
Official reserve transactions balance	-9,821
United Kingdom	
Merchandise trade balance	393
Current account balance	-476
Basic balance	266
European Economic Community	
Merchandise trade balance	1,718
Current account balance	497
Basic balance	532
Other Western Europe	
Merchandise trade balance	879
Current account balance	-140
Basic balance	188
Canada	
Merchandise trade balance	-1,676
Current account balance	-596
Basic balance	-1,651
Japan	
Merchandise trade balance	-1,246
Current account balance	-1,545
Basic balance	-1,577

Table 2

US Market Share of Exports and Imports of Selected Countries and Areas in 1970

	Imports from US (Million US $)	Percent of Total Imports	Exports to US (Million US $)	Percent of Total Exports
Canada	9,460	71	10,540	65
Japan	5,570	29	6,010	31
Austria	120	3	120	4
Belgium-Luxembourg	1,000	9	700	6
Denmark	320	7	260	8
Finland	130	5	110	5
France	1,900	10	960	5
Germany	3,290	11	3,120	9
Italy	1,550	10	1,360	10
Netherlands	1,310	10	500	4
Norway	260	7	140	6
Sweden	490	9	400	6
Switzerland	550	9	460	9
United Kingdom	2,820	13	2,260	12
Austria, New Zealand, South Africa a/	1,470	19	1,057	14
Latin America a/	4,870	38	4,214	32
Far East a/	3,438	20	3,033	24
Middle East a/	1,282	18	346	4
Africa a/	863	9	793	7

a. 1969.

Table 3

Direction of Exports of Selected Countries
1970

Percent of Total Exports

From	Canada	United States	Japan	EEC	Belgium-Luxembourg	France	Germany	Italy	Netherlands	EFTA	Switzerland	United Kingdom	Rest of World
Canada	-	65.3	4.7	7.1	1.1	0.9	2.3	1.1	1.7	10.8	0.2	8.9	12.1
Japan	2.9	31.1	-	6.7	0.8	0.7	2.8	1.0	1.4	5.8	0.9	2.5	53.5
Belgium-Luxembourg	0.4	6.0	0.7	68.6	-	19.8	24.6	4.7	19.4	10.9	2.0	3.6	13.4
France	0.9	5.3	0.9	48.3	11.0	-	20.6	11.1	5.6	13.6	4.7	4.1	31.0
Germany	0.9	9.1	1.6	40.1	8.2	12.4	-	8.9	10.6	23.8	6.1	3.6	24.5
Italy	1.0	10.3	1.0	42.8	3.7	12.8	21.6	-	4.7	14.2	4.7	3.8	30.7
Netherlands	0.6	4.3	0.7	62.0	14.0	10.0	32.6	5.4	-	15.6	1.9	7.0	16.8
Switzerland	1.4	9.0	3.2	37.4	2.3	8.2	14.8	9.4	2.7	21.2	-	7.2	27.8
United Kingdom	3.6	11.7	1.8	21.8	3.6	4.3	6.3	3.0	4.6	15.8	2.6	-	45.3